No. 22352

IN THE

United States Court of Appeals For the Ninth Circuit

PETER PAN SEAFOODS, INC., a Washington corporation,
Appellant,

v.

THE UNITED STATES OF AMERICA,
Appellee.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON, SOUTHERN DIVISION

HONORABLE GEORGE H. BOLDT,
United States District Judge

REPLY BRIEF OF APPELLANT TAXPAYER

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REPLY BRIEF OF APPELLANT TAXPAYER

ARGUMENT IN REPLY

The Trial Court Did Not Hold That Ajax Was a Conduit, Agent, Alter Ego, Tool, Instrumentality, Straw Man or Puppet of Appellant Taxpayer and Any Such Assertion Is Incompatible with the Admitted Facts.

The entire argument made by the Government on the question raised under Section 61[1] in this case is based on the assertion that Ajax was nothing but a conduit, agent, alter ego, tool, instrumentality, straw man or pup-

1. Section 61(a)(12) of the Internal Revenue Code of 1954.

pet of Appellant taxpayer. This assertion is made, repeated and reasserted until it assumes the character of an incantation as the brief progresses.[2] The principal decisions of the Supreme Court of the United States and other Courts of Appeal, which establish that in matters relating to the Federal revenue form must give way to substance, are cited in the most orthodox fashion (Gov't Br. 14-21, 31-32). These are all admittedly sound decisions and some of them represent landmarks in the development of the law relating to Federal taxation.

The difficulty is that neither the Government's assertion nor the principles enunciated by this respectable array of authorities is directed at the issue presented by this appeal. The Trial Court did not hold, or even suggest, that Ajax was not a real corporation, organized by real stockholders, for a real purpose. Nor did the Trial Court hold or suggest that Ajax did not in fact buy the mortgage notes in question, borrow substantial sums from a bank and from its stockholders to pay for them, pledge them to the bank as security for its indebtedness, collect interest and principal on the indebtedness evidenced by the notes, and eventually become the sole stockholder of Appellant taxpayer, the position which it holds to this day. Indeed, any such holding on the part of the Trial Court would have been preposterous in face of the detailed factual account of the organization and history of Ajax and its relationship to Appellant taxpayer over the period from its organization in May, 1956, until the trial of this action in January of 1967, all of which has been stipulated and agreed to as outlined in the Statement of Facts in Appellant taxpayer's Opening Brief (Br. 7-23).

2. Government Brief, pp. 9, 20, 21-22, 31, 33, 37.

None of these facts are challenged by the Government as indeed they could not be, since the Government had agreed in the Pre-Trial Order that they are true (R. 84-103). It has never been suggested that the 49 paragraphs detailing the whole history of these transactions which make up the admitted facts in this proceeding, and the 40-odd related exhibits (Exs. A-I-UU), constitute or involve a vast web of fiction or unreality. These admitted facts state in concise, clear language what was done and what happened in connection with the organization of Ajax, its acquisition of the mortgage notes and its subsequent dealings with them, and how, through a series of unforeseen developments Mr. Bez and the Calverts came to acquire all of the stock of Ajax, and Ajax became the sole stockholder and owner of Appellant taxpayer. This chronology of admitted facts does not permit the conclusion or even an implication that Ajax is, or ever was, a straw man, puppet, instrumentality, tool, alter ego, or agent of Appellant taxpayer, which it now owns lock, stock and barrel (R. 99). That Ajax was a mere conduit for the acquisition of the mortgage notes and their eventual transmission to Appellant taxpayer is not even suggested by the Trial Court. Here again the detailed chronology of the admitted facts is entirely incompatible with any such contention.

On the contrary, the decision of the Trial Court on the Section 61 issue was based and rests solely on the legal conclusion which the Court derived from its finding that tax avoidance was the primary, dominant, moving purpose for the formation of Ajax and for its single business activity in purchasing the mortgage notes (R. 117, 127). What the Court did hold was that since tax avoidance was the primary, dominant, moving purpose, the various transactions should be given an effect for Federal tax purposes different than what the effect would be in the absence of the tax avoidance purpose. In other words, because of the fact that Appellant taxpayer had good reason to purchase the notes but did not do so because of the tax consequences and the fact that stockholders of Appellant taxpayer decided that under these circumstances they should purchase the mortgage notes instead (since no unacceptable tax consequence would thereby result), the Trial Court concluded that the organization of Ajax by the stockholders to purchase the notes must be regarded as, in substance, a purchase by Appellant taxpayer, solely because of the tax avoidance purpose and intent which admittedly permeated the whole transaction.

It is the position of Appellant taxpayer that this was clearly error on the part of the Trial Court. As stated in Appellant taxpayer's Opening Brief, it is Appellant taxpayer's position that the motive of tax avoidance will not establish liability if the transaction does not do so without it (Br. 31-40). This principle is so firmly established by decisions of the Supreme Court, headed by *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935), and by decisions of the various Circuit Courts, including this Court, that it is no longer subject to serious contention. Furthermore, it has been firmly established that in order to test the true tax consequences of a transaction, the tax avoidance intent or motive should be set aside so that the transaction may be measured as though the tax avoidance element did not exist. *Knetsch v. United States*, 364 U.S. 361, 365, 5 L.Ed.2d 128, 131, 81 S.Ct. 132 (1960), *affirming Knetsch v. United States*, 272 F.2d 200 (9 Cir., 1959).

United States v. Lynch

The Government appears to suggest that the decision by this Court in *United States v. Lynch,* (9 Cir., 1951) 192 F.2d 718, is contrary to the principle stated above. We do not believe this to be the case, and a somewhat detailed examination of that case will demonstrate the fallacy of the Government's position.

In *Lynch,* Washington Fruit and Produce Co., which was in the business of growing, handling, warehousing and marketing fresh fruits and vegetables, declared a dividend in kind consisting of 21,977 boxes of apples to its three stockholders. At the meeting at which the dividend was declared, the three stockholders entered into an agreement with the corporation whereby the corporation was to dispose of the apples and account to the stockholders for the net proceeds from the sale. The apples were in the corporation's warehouse at the time, and were immediately sold by the corporation in the normal course of its business in the same manner as if no dividend had been declared. The corporation continued to engage in its normal business for about two months thereafter and was then liquidated.

This Court held that since it was intended all along that the corporation would proceed to sell the apples in the usual course of its business as a going concern, and that the corporation did in fact do so, the purported dividend must be ignored for tax purposes. Consequently, the gain on the sale of the apples was corporate income. The declaration of the dividend in apples, coupled with the three stockholders' agreement that the corporation proceed to sell them in the usual manner and distribute the cash proceeds to the shareholders, was obviously not intended to result in a real distribution of the apples or a real sale of them by the stockholders. All that was intended, and all that really happened, was that the stockholders receive a cash dividend in the amount of the net proceeds from the sale of the apples. As far as the sale of the apples was concerned, nothing was done nor intended to be done, differently than if no dividend had been declared. Thus, the purported dividend accomplished nothing and was not intended to accomplish anything, other than the avoidance of the tax on the sale of the apples by the corporation. In other words, insofar as the apples were concerned, the dividend did not represent a real transaction at all, and this Court very properly held that since the corporation sold the apples, it was responsible for the resulting tax on the sale.

The true import of the Court's decision in *Lynch* is perhaps best illustrated by this Court's later decision in *Gensinger v. Comm'r*, (9 Cir., 1953) 208 F.2d 576. In that case, the sole stockholder of a corporation which was engaged in the business of producing cherries, apricots and peaches on its farm near Wenatchee, Washington, had for some time intended to liquidate the corporation. In the summer of 1943, while the fruit was being harvested, proceedings for the liquidation of the corporation were formally commenced by necessary filings with the state authorities on July 20. It had been the practice of the corporation to market its fruit through a local cooperative marketing association. By July 20, the cherry crop had already been delivered to the co-op and sold. The apricot crop had been delivered to the co-op prior to July 20 but had not then yet been sold. The peach crop was delivered to the co-op and sold in September. Prior to the filing on July 20, which formally commenced the dissolution proceeding, the stockholder orally advised the co-op that the corporation was to be dissolved and directed that the apricot and peach crops be handled for his individual account. On the basis of this instruction and the fact that the accounts of the co-op were altered accordingly to show that sales of the fruit would henceforth be for the individual account of the stockholder, taxpayer contended that the profit on the sales was not attributable to the corporation.

This Court held that the cherry crop had not been distributed to the stockholder because it had been sold prior to July 20, and thus the proceeds of the sale of that crop were clearly taxable to the corporation. With respect to the apricot and peach crops, however, this Court concluded that a distribution had actually occurred and that the sale of those crops by the co-op were for the account of the stockholder and not the corporation.

The Court stated at page 579:

> "The problem here is simply whether the distribution was made."

Apparently answering the Commissioner's contention that this result was contrary to the holding in *Lynch*, the Court said at page 578-579:

> "Nor are we here concerned with an attempt of a going concern to avoid a tax on the sales of its products by the ritual of a paper transfer of such products to shareholders as dividends, followed by sales of such products in the ordinary course of the corporation's business, as in *United States v. Lynch*, 9 Cir., 192 F.2d 718."

The Court pointed out that there were two courses of action open to the stockholder, as follows (page 581):

> "He could sell the apricot and peach crops for the corporation as trustee in dissolution, through Skookum, and take the proceeds as liquidating dividends, in which event the proceeds of the sale would be taxable to the corporation, * * *"

or

> "as trustee, he could distribute the crops to himself as liquidating dividends and sell them as an individual, through Skookum, thus avoiding the tax to the corporation."

Since the stockholder chose and actually carried out the second alternative, he avoided the tax.

Lynch and *Gensinger,* taken together, clearly illustrate the error of the Government's apparent interpretation of *Lynch.*

As in *Lynch* and *Gensinger,* the question in the case at bar is the legal consequences of what was actually done, without reference to whatever tax avoidance motives or intentions that may have been involved.

To characterize the organization of Ajax, the numerous subscriptions for its stock and notes, its sizable bank borrowings, its purchase of the mortgage notes involving the presentation of formal written offers to the 68 beneficiaries of the trust which owned the mortgage notes, its pledge of the mortgage notes as security for its bank indebtedness, its collection of principal and interest on the mortgage notes, its payment of its bank loan in various installments over a period of five years, its eventual acquisition of all of Appellant taxpayer's stock from the numerous shareholders who theretofore held it, and the multitude of other transactions and functions which the admitted facts establish it engaged in, as paper ritual without substance, would be to abandon reason. The admitted facts establish these things were actually done. Under the decisions of this Court and of the Supreme Court of the United States, the tax consequences must be determined accordingly. *Twin Oaks Co. v. Comm'r,* (9 Cir., 1950) 183 F.2d 385; *Gensinger v. Comm'r,* (9 Cir., 1953) 208 F.2d 576; *Gregory v. Helvering,* 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935); *Knetsch v. United States,* 364 U.S. 361, 5 L.Ed.2d 128, 81 S.Ct. 132 (1960).

Viewing the admitted facts on this basis, Ajax was a corporation organized by its stockholders (who were largely stockholders of Appellant taxpayer) to acquire the mortgage notes, and it did acquire them, hold them, and deal with them as an owner. The only connection or relationship of Ajax to Appellant taxpayer arises from the fact that they had substantially the same stockholders. As established by the authorities cited and discussed in Appellant taxpayer's Opening Brief, this does not justify the attribution of the purchase to Appellant taxpayer (Br. 43-47). *Koppers Co.,* 2 T.C. 152 (1943); *D. Bruce Forrester,* 4 T.C. 907 (1945).

It Was the Stockholders, Not Appellant Taxpayer, Who Determined How and by Whom the Mortgage Notes Should Be Purchased.

The Government seems to assert[3] that Appellant taxpayer somehow controlled Ajax as a parent controls its subsidiary. But Ajax was not a subsidiary of Appellant taxpayer. Appellant taxpayer owned not one share of

3. Gov't Br. 16-22, 32-34, 36-37.

stock of Ajax. Ajax was organized and controlled by its own stockholders. These stockholders comprised a substantial number of individuals and several entirely unrelated corporations. It is true that the larger portion of these stockholders were also stockholders of Appellant taxpayer. But they controlled Appellant taxpayer, not vice versa. To resort to an analogy which may illustrate the point, the fact that a brother and a sister have the same father does not make the brother a parent of the sister, or place her in his charge. The father is the parent of both children and controls each of them, but neither child controls the father or the other child. Brother/sister corporations are in the same relationship to their common stockholder, and to each other.

In the case at bar, it is stipulated that when it was determined that Appellant taxpayer should not purchase the mortgage notes, certain stockholders of Appellant taxpayer then began to explore the possibility of joining with other stockholders for the purpose of attempting to purchase the mortgage notes, and Ajax was organized for that purpose. The larger part of the stockholders of Appellant taxpayer subscribed for stock and stockholder notes of Ajax to provide a substantial portion of the funds required to purchase the notes, and Ajax proceeded to purchase the notes accordingly (R. 87-92). Complete control and ownership of Ajax was thus vested in its stockholders, and they were certainly not puppets, tools or alter egos of Appellant taxpayer which they themselves also owned and controlled. Thus, to say that Appellant taxpayer controlled Ajax, or that Ajax was a mere agent of Appellant taxpayer is simply not compatible with the stipulated facts. If Ajax was an agent of anyone, it was the agent of its stockholders. It was the stockholders who set out to acquire the notes.

It is obvious that the ownership of Appellant taxpayer's stock must have been an important consideration in the determination of these stockholders to attempt to acquire the mortgage notes. Had they owned no interest in Appellant taxpayer, these particular persons would probably have had little interest in making this particular additional investment. But this was a decision and determination by the stockholders, as such, not of Appellant taxpayer. It had already been determined that Appellant taxpayer could not purchase the notes because the cost, plus the tax, "would be prohibitive" (R. 88). Nevertheless, as the substantial owners of the enterprise, they still desired to acquire these important outstanding securities—the mortgage notes—the holders of which were in a position to foreclose their mortgages on Appellant taxpayer's principal properties in the event of default. It is undoubtedly true that had it not been for the tax consequences, the stockholders would have preferred that Appellant taxpayer purchase the notes; and it is undoubtedly also true that their decision to purchase the notes themselves, rather than cause or permit Appellant taxpayer to do so, was dictated primarily, if not solely, by the tax considerations as the Trial Court found. But there can be no question that this alternative was freely open to these stockholders, and having selected this alternative and having proceeded to purchase the notes accordingly, employing Ajax as the vehicle for that purpose, the tax consequences must be determined by what they actually did, not by what they might have done.

Payments of Interest and Principal to Ajax Were an Affirmative Recognition of the Continued Existence of the Indebtedness Evidenced by the Mortgage Notes.

Interest on the mortgage notes was payable annually in the amount of approximately $66,000.00 per year. Prior to the purchase of the notes by Ajax in 1957, Appellant taxpayer had paid the interest as it accrued, except for the two years ended 3-31-54 and 3-31-55. Ajax purchased the notes on February 21, 1957, and on April 2, 1957, Appellant taxpayer made the regular annual interest payment for the year ended 3-31-57 to Ajax in the amount of $66,737.28. Out of the funds so received on account of this interest payment, Ajax paid $60,000.00 to the bank on May 17, 1957, to be applied in reduction of its bank indebtedness (R. 92-94; Exs. O, Q).[4] Also, in the negotiations on behalf of Ajax with the bank prior to the purchase, Mr. Bez had promised the bank that if it granted the loan to Ajax, Appellant taxpayer would make a substantial payment on the indebtedness evidenced by the mortgage notes in the near future. The Board of Directors of Appellant taxpayer, at its annual meeting May 17, 1957, with the approval of its stockholders given at their annual meeting held on the same day (Exs. AA, BB), authorized a principal payment in the amount of $400,000.00 to Ajax on the indebtedness evidenced by the mortgage notes, and this payment was made several days later. Of this sum, Ajax paid the bank $399,677.00

4. The Government now concedes (Gov't Br. 42) that the first payment of interest to Ajax was made on April 2, 1957, rather than May 17, 1957 as erroneously found by the Trial Court (R. 126). Accordingly, Ajax's first payment to the bank was not made until approximately one and one-half months after it had received its first payment from Appellant taxpayer.

in reduction of its bank indebtedness. The $400,000.00 payment to Ajax constituted a prepayment of principal on the notes (Finding of Fact No. 8, R. 126). The facts above outlined are clearly stated in the Statement of Facts in Appellant taxpayer's Opening Brief and are summarized in the argument on pages 47 and 48 thereof. These are the only funds paid out by Appellant taxpayer in connection with the transactions involved in this case prior to the regular annual interest payment for the year ended 3-31-58 (R. 94).

On the basis of these facts, the Government Brief asserts (at page 33) that the major portion of the funds used to purchase the mortgage notes was provided by Appellant taxpayer. Whatever implication may be intended by this statement is adequately refuted by the facts upon which it is based. As pointed out in Appellant taxpayer's Opening Brief (Br. 45-48), these payments of interest and principal on the notes after they were acquired by Ajax provides solid proof that all parties recognized the notes as representing a fully outstanding indebtedness of Appellant taxpayer, and dealt with them as such, including the bank which held the notes as the only collateral for its loan to Ajax.

As stated in *D. Bruce Forrester,* 4 T.C. 907 (1945) (acq. 1945 C.B. 3), where the same argument was made with reference to a similar situation (page 921):

> "These payments are evidence of good faith."

Ajax' Purchase of the Mortgage Notes in 1957 Was Completely Unrelated to the Reorganization of Peninsula Packers in 1959.

Among the various catch-words with which the Government has attempted to characterize Ajax is the assertion that Ajax was a mere conduit.

It is true that on June 29, 1959, Ajax, which was now the sole stockholder of Appellant taxpayer, contributed the mortgage notes to the capital of Appellant taxpayer, thereby converting the full amount of its investment in the notes into an additional equity investment in Appellant taxpayer (R. 100-101). However, much water had run over the dam in the period since the purchase of the notes by Ajax more than two years before.

When Ajax negotiated for and purchased the mortgage notes in February, 1957, Appellant taxpayer had 27 stockholders and Ajax had 21 stockholders (Ex. SS). At that time, Mr. Bez, together with a corporation which he controlled, and the partnership Peninsula Packers, only owned approximately 25 per cent of Appellant taxpayer's stock (R. 95-96; Ex. S). While these holdings represented the largest single block of Appellant taxpayer's stock, the remaining 75 per cent was held by other individuals and groups, no individual or group having clear control of the company (R. 125). There is nothing in the admitted facts and nothing in the record which would indicate that there was any thought or contemplation whatsoever in 1957 that Bez and/or Peninsula Packers would, or even might, acquire all of the outstanding securities of Appellant taxpayer, or of Ajax, or of either of them. Indeed, the later events which led to this change of ownership, as disclosed by the undisputed facts (R. 97-101) themselves demonstrate that the change in ownership and the events which followed it, including the contribution of the notes to Appellant taxpayer, had no relationship to the original acquisition of the notes.

As stated in the Statement of Facts in Appellant taxpayer's Opening Brief (Br. 18-23), Appellant taxpayer's Alaskan salmon fishing operations during the 1958 season (the second season after the purchase) were relatively successful and resulted in a substantial profit. However, the immediate prospects of the elimination of salmon traps in Alaska and other problems created by Alaska statehood caused certain of the directors and stockholders of Appellant taxpayer to be pessimistic with respect to the prospects for the 1959 season. A meeting of the Board of Directors was held on January 14, 1959 in the California Club, Los Angeles, California, to consider the situation and determine the future course of the company and its business, in view of the Alaska situation (Ex. DD). Proposals to liquidate the company or to consolidate its operations with those of Peninsula Packers, which was also engaged in the salmon canning business in Alaska, were considered. However, substantial objections were raised to each of these possibilities. Two of the directors then joined in a suggestion that Mr. Bez be given an option until March 31, 1959 on all of the stock and notes of Appellant taxpayer and Ajax held by the other persons present at the meeting, on condition that no decision would be made during the period of the options to operate or not to operate Appellant taxpayer's plants for the coming season, and that Mr. Bez would not permit any substantial funds of the company to be committed for the operation of the company's plants during that time unless he was instructed to do so by the Board. All parties present at the meeting indicated that they would be willing to give such an option to Mr. Bez and that they would use their best offorts to persuade the other security holders whom they respectively represented to join in such an option. As a result, by March 6, 1959 Mr. Bez had received options covering all of the outstanding stock and unsecured notes of Appellant taxpayer and of Ajax, except the stock and notes which he and Peninsula Packers already owned or controlled (R. 97-99).

These options were taken by Mr. Bez for the benefit of Peninsula Packers (R. 97-98) which, as above stated, was also engaged in the salmon canning business in Alaska. Peninsula Packers was a partnership, the sole partners of which were two corporations, Trans-Pacific Fishing & Packing Co. and Calvert Corporation (R. 96). Peninsula Packers and Trans-Pacific owned and operated a substantial number of fishing boats, facilities and equipment, and also owned the stock of Global Fishing Company, which was also engaged in fishing operations in Alaska (Ex. HH). As a result of a reorganization and consolidation of its other holdings and the exercise of the above-mentioned options, Peninsula Packers became the sole stockholder of The Ajax Company, The Ajax Company became the sole stockholder of Appellant taxpayer, and the bulk of the fishing operations and operating assets of the various components were transferred to Appellant taxpayer (R. 97-100; Exs. EE-JJ). The details of this reorganization are set forth on pages 20-22 of the Opening Brief.

The operation of Appellant taxpayer's expanded business required large borrowings from banks, particularly prior to and during the Alaskan fishing season, to finance its salmon pack. Large bank credits were also required in connection with the purchase of salmon packed by others. In this connection, Appellant taxpayer was dependent upon lines of credit extended to it by its banks (R. 96). Upon the acquisition of all of the outstanding stock of Appellant taxpayer by Ajax, the banks indicated it would be desirable to eliminate the mortgage indebtedness owing by Appellant taxpayer under the mortgage notes. Consequently, on June 29, 1959, Ajax entered into a letter agreement with The Bank of California, whereby Ajax agreed to pledge all of the issued and outstanding stock of Appellant taxpayer to the bank as security for its bank loan, and the bank agreed to accept said stock as substitute collateral and release the mortgage notes from its pledge. Ajax further agreed that upon release to it of the mortgage notes, it would contribute them to the capital of Appellant taxpayer so that said mortgage indebtedness would be converted into equity capital of Appellant taxpayer. Said substitution of collateral was effected and, upon the release of the mortgage notes by the bank to Ajax, Ajax contributed the same to the capital of Appellant taxpayer as above stated. Entries were made in Appellant taxpayer's books of account to reflect the increase of its paid-in capital in the amount of the unpaid balance of the mortgage notes and a corresponding reduction in its long-term debt (R. 100-101); Exs. KK, LL).

Thus, it is a fact that the mortgage notes, which were purchased by Ajax in February, 1957, were eventually transferred to Appellant taxpayer some two years and two fishing seasons later, in June, 1959. However, it is equally clear that Ajax was not a mere conduit for the transmission of the notes.

In the sense that the term "conduit" is used by the

Government and by the authorities cited by the Government, a conduit is a mere instrumentality whereby, pursuant to a preconceived plan and interrelated steps, a mortgage note, a share of stock, or a bulldozer is transferred indirectly from one owner to its intended recipient. In such case, the interposition of the conduit merely operates to bring the transaction within some technical definition, such as that of a reorganization, or to disguise or conceal the intended end result. *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935); *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 58 S.Ct. 393, 82 L.Ed. 474 (1938); *Griffiths v. Comm'r*, 308 U.S. 355, 60 S.Ct. 277, 84 L.Ed. 319 (1939); *Comm'r v. Court Holding Co.*, 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 981 (1945).

In the case at bar, it is apparent in the admitted facts that the final disposition of the mortgage notes as a contribution to the capital of Appellant taxpayer could not have been foreseen, much less be the result of a plan formulated at the time of their acquisition in 1957.

It is basic that for a series of steps to be treated as a single transaction, as the Government appears to contend, the steps must be mutually interdependent. *Here, such interdependence is completely absent.* The rule is well stated by the Third Circuit Court of Appeals in *AFC-Brill Motors Co. v. Comm'r*, 189 F.2d 704 (3 Cir., 1951), at page 707, as follows:

> "The Tax Court suggested in its opinion that one of the tests for determining whether a series of steps is to be treated as a single transaction for tax purposes is that of the mutual interdependence of the steps. Were the steps so interdependent that the legal relations created by one transaction would have

been fruitless without the completion of the series? The court concluded that the steps here involved did not meet this test of interdependence. We think that the court was right in considering the test an appropriate one and in concluding that the transactions involved in this case did not meet it."

"* * *

"* * * we think that at the very least it must appear that the entire series of transactions has been carried out in accordance with a prearranged plan and that they are in fact component steps of a single transaction."

THE SECTION 269(a)(1) ISSUE[5]

Appellant Taxpayer Did Not Acquire Control of Ajax.

The Government blandly asserts[6] without citation of applicable authority that when persons owning in excess of 50 percent of Appellant taxpayer acquired in excess of 50 percent of the stock of Ajax, Appellant taxpayer *then* acquired indirect control of Ajax.

This assertion is a complete *non sequitur*. As observed in an earlier section of this Reply Brief (pp. 9-10), Appellant taxpayer did not own or control one single share of stock of Ajax. Ajax was owned and controlled solely by its stockholders, and, while a larger portion of these

5. The full text of Section 269(a), including both subsections (1) and (2), is set forth in Appendix A hereof, *infra*. In the case at bar, there is no claim or basis for claim that subsection (2), relating to corporate acquisitions of property of another corporation not controlled, directly or indirectly, by the acquiring corporation *or its stockholders*, has any application. First, this case does not involve the acquisition of property by one corporation from another and, second, the express stockholder control provision of subsection (2) would render the same inapplicable in any event. *Brick Milling Co.*, 22 T.C.M. 1603 at 1608 (1963); *Southland Corp. v. Campbell*, 358 F.2d 333 at 337 (5 Cir., 1966).

6. (Govt. Br. 27, 38).

stockholders were also stockholders of Appellant taxpayer, the stockholders of Appellant taxpayer controlled Appellant taxpayer, not vice versa. To state it tersely, brother/sister corporations are each controlled by common stockholders, but neither of them controls the other for purposes of application of the control provisions of Section 269(a)(1). This was made clear in *Brick Milling Co.*, 22 T.C.M. 1603 (1963).

Insofar as Appellant taxpayer is aware, there is no authority in support of the Government's indirect control argument in this case. Neither reason nor authority supports the Government position.

Nor does the case of *Southland Corporation v. Campbell*, 358 F.2d 333 (5 Cir., 1966)[7] support the Government's position with respect to this crucial point. In *Southland*, the controlling stockholders (Murchisons) of a defunct loss corporation, Caribbean, owned 44.9 percent of the stock of a profit corporation, Old Cabell's. After the possibility of a merger between the two corporations had arisen in June of 1956, the Murchisons, on July 11, 1956, by purchase increased their stockholding in Old Cabell's to 50.4 percent. Shortly thereafter, on August 17, 1956, the Murchisons contributed their controlling stock in Old Cabell's to Caribbean. On October 1, 1956, Old Cabell's was merged into Caribbean which, as the surviving corporation, then changed its name to New Cabell's and continued to carry on Old Cabell's profitable business. The taxpayer, Southland Corporation, which thereafter succeeded to New Cabell's, carried forward the 1954-1956 losses of Caribbean as net operating loss deductions from post-merger income. The commis-

7. (Govt. Br. 27).

sioner disallowed the deductions under the authority of Section 269(a) and the District Court upheld that determination. The Fifth Circuit Court of Appeals reversed. The Circuit Court quite properly noted that Section 269 (a) is applicable only "in carefully circumscribed situations" and held that since the Murchisons owned at least 50 percent of the stock of both corporations immediately prior to the acquisition of Old Cabell's assets by Caribbean, Section 269(a)(2) by its plain terms was not applicable. The basis of the Court's decision on this particular point is set forth in its footnote 7 on page 337 of the opinion as follows:

> "Section 269(a)(2), note 2 *supra,* restricts its applicability to the acquisition by one corporation of another corporation 'not controlled * * * immediately before such acquisition, by such acquiring corporation *or its stockholders.*' (Emphasis added)."

As heretofore noted, subsection (2) of Section 269(a) is not an issue in the case at bar.[8]

In addition, the Court in *Southland* further held that if, in fact, the Murchisons acquired control of Old Cabell's for the proscribed purpose, as an integral component of a unified plan to merge Old Cabell's into Caribbean and thus secure the benefit of Caribbean's operating losses to Old Cabell's, Section 269(a)(1) would apply. However, as noted by the Court, in such case the subsequent intended merger would be an absolute necessity to the application of Section 269(a)(1) because, as observed by the Court at page 337:

> "This transaction itself did not produce any tax benefit to Murchison Brothers; the further step of

8. See footnote 5, *supra.*

merging Old Cabell's with Caribbean was necessary before achieving this result."

Obviously, *Southland* is inapplicable in the case at bar. In *Southland*, the Court very carefully points out that common ownership of the two corporations, without subsequent merger of the two, would not serve to give one corporation control over the other, for the purposes of Section 269(a)(1). In the case at bar, Appellant taxpayer did not acquire one single share of the stock of Ajax, and no merger between Appellant taxpayer and Ajax has ever taken place to the present day.

It Is Appellant Taxpayer Not Its Stockholders Who Has Claimed the Deductions in Question. As Appellant Taxpayer Did Not Acquire and Was Not Acquired, Section 269(a)(1) Is Inapplicable.

Finally, the Government asserts that notwithstanding the fact Appellant taxpayer did not acquire control of Ajax and Section 269(a)(1) may be inapplicable by its terms, this Court should nonetheless render it applicable by judicial construction because Appellant taxpayer's stockholders have a "beneficial interest" in the net operating loss deductions claimed by Appellant taxpayer (Gov't Br. 39).

The Government attempts to rest this last gasp argument on this Court's decision in *Comm'r v. British Motor Car Distributors Ltd.*, 278 F.2d 392 (9 Cir., 1960), wherein this Court applied Section 129(a) of the 1939 Code to deny an *acquired* loss corporation the right to carry forward its pre-acquisition losses as deductions from its post-acquisition income. In other words, in *British Motor Cars*, this Court correctly held that the deductions, etc., which are disallowed by Section 269(a)(1) may be those of an acquired corporation as well as those of an acquiring corporation (or individual as the case may be).

The actual basis of this Court's decision which is conveniently ignored by the Government is found in a short passage from its opinion at page 394:

> "It is not the fact that they are stockholders which subjects them to scrutiny. Rather, it is the fact that they are the persons specified by the section: those who have acquired control of the corporation."

Thus this Court did not hold, as suggested by the Government, that Section 269(a)(1) may be extended beyond its plain terms to deny a "deduction, credit or other allowance" to a corporation, as Appellant taxpayer, which neither acquired nor was acquired.

In its Opening Brief, Appellant taxpayer demonstrated by logical argument supported by citation of applicable authorities (Br. 55-66) that by its plain terms, Section 269(a)(1) is inapplicable to the factual situation presented in the case at bar for two separate, independent reasons. First, Appellant taxpayer did not, directly or indirectly, acquire control of Ajax and Ajax did not, directly or indirectly, acquire control of Appellant taxpayer (Br. 55-61). In other words, neither Appellant taxpayer nor Ajax directly or indirectly acquired the requisite 50% stock ownership in the other. *Brick Milling Co.*, 22 T.C.M. 1603, 1610 (1963). Second, Appellant taxpayer did not secure the benefit of a deduction, credit or other allowance which it would not otherwise have enjoyed (Br. 61-66). *John F. Nutt,* 39 T.C. 231, 250 (1962), *Rev'd on another point, Nutt v. Comm'r,* 351 F.2d 452 (9 Cir. 1965); *Cromwell Corp.,* 43 T.C. 313 (1964).

For these reasons the decision of the Trial Court on the Section 269(a)(1) issue, as well as the Section 61(a)(12) issue, should be reversed.

CONCLUSION

Upon the basis of the foregoing Reply to the Government's Brief and for the reasons set forth in Appellant Taxpayer's Opening Brief, Appellant taxpayer again respectfully submits that the judgment of the Trial Court should be reversed with directions to enter judgment in favor of Appellant taxpayer.

Respectfully submitted,

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APPENDIX A

Section 269(a) of the Internal Revenue Code of 1954 (Prior to 1963 Amendment).

SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INCOME TAX

(a) IN GENERAL—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.